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A Review of Alternative Debt Strategies

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Seven years later, international debt strategy has not moved beyond crisis management. If conditions worsen, the political obstacles to formal, involuntary debt forgiveness may have to be removed.

This comprehensive review of debt strategies includes recent debt proposals that recommend alternatives to market-based debt workouts. Proposals differ widely depending on whether they seek new lending or broad-based debt relief and forgiveness. Their common, explicit aim is to reduce the negative net resource transfers to the creditors and to ease the debt burden of the highly indebted countries.

Commercial creditors and official circles in industrial countries have so far shunned the idea of interest concessions or debt forgiveness to highly indebted countries. Governments have a political problem using public funds ("taxpayers' money") to finance debt concessions and/or to protect banks from country defaults, particularly in an environment of budgetary austerity. Banks fear that large-scale involuntary debt reduction would entail substantial write-offs which — if they exceeded existing loss provisions and eroded capital — could harm highly leveraged banks. There is also ideological resistance to the idea of resolving a "market" problem — debt recovery by private commercial banks — by nonmarket means. And both official and market creditors point to the risk of moral hazard — that formal concessions would "reward bad conduct," penalizing countries that have persevered with adjustment. These argu-

ments tend to gloss over the increasing politicization of the problem in debtor countries themselves.

So far creditors have stayed one step ahead of the debtors. Banks have trimmed their exposures and accumulated large provisions to reduce their vulnerability to defaults; creditors have increasingly recognized the pragmatism of selective voluntary debt reduction; industrial countries and multilateral agencies have stepped in with sizeable emergency loans and lending commitments to deal with isolated crises with individual debtors (most recently in Mexico and Argentina). The international community has raised the stakes as needed but after seven years the debt strategy has not yet moved beyond crisis management.

If Latin American debtors revive the idea of a "debtor cartel," or if social or economic conditions worsen (with a world recession, for example), crisis management may no longer suffice. A purely political decision may then be necessary to remove obstacles to formal, involuntary debt forgiveness. The amount to be forgiven under such conditions could turn out to be higher than if more timely action had been taken.

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**by
Eugene L. Versluysen**

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A REVIEW OF ALTERNATIVE DEBT STRATEGIES

I. The Debt Crisis in Perspective

Mexico's announcement, in August 1982, that it would be unable to continue to service its external debt of \$86 billion triggered the debt crisis. At that time, Mexico's debt had reached the equivalent of 53 percent of its GNP, and of more than 310 percent of export earnings. The proximate cause of Mexico's near default was the rapid rise in the real cost of debt service during the preceding years. Real interest rates on external reached a peak of close to 25 percent in 1982. ^{1/} That burden severely eroded the country's debt-service capability in an environment of global economic recession, falling oil prices and unfavorable export prospects.

The US Treasury immediately came to Mexico's rescue with a \$1 billion prepayment for future oil imports, supplemented by a \$925 million bridging loan. A second bridging loan of equal amount was provided by the Bank for International Settlements (BIS). This combined package gave the country time to negotiate an adjustment program with the IMF and to arrange for the rescheduling of a part of its commercial debt.

While Mexico's negotiations with its bank advisory committee were under way--they took almost one year to complete--changing perceptions of country risks induced credit contamination that caused a drastic reduction in the volume of commercial lending to highly-indebted developing countries. From 1982 to 1983 net disbursements of long-term commercial funds ^{2/} to the seventeen highly-indebted middle-income countries--the HICs ^{3/}--dropped by some 60 percent, from \$28 billion to \$12 billion. After total debt service payments of \$48 billion--including \$29 billion in interest--in 1983, the decline of new lending changed the direction of net resource transfers to those countries. A net inflow of \$3.7 billion in 1982 became an outflow of \$10 billion in 1983. (Table 1) As most HICs were using new credits to refinance debt falling due, the emergence of negative resource transfers spread illiquidity and generalized the debt crisis among the largest debtors.

^{1/} One of the more conventional methods to calculate real interest rates is to deflate nominal interest rates by the unit price of the debtor's exports. Using that method to deflate US dollar LIBOR, the developing countries' real borrowing costs in dollars rose from -7 percent in 1980 to +15 percent in 1981, and +23 percent in 1982. That increase was caused by the combination of anti-inflationary monetary policies in industrial countries (rising nominal rates) and falling commodity prices (falling cost deflator).

^{2/} Bank loans and new foreign and international bond issues.

^{3/} In the World Bank's classification these seventeen countries are: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cote d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela and Yugoslavia.

That crisis, which is now in its seventh year, has left its mark on all problem debtors and has acquired geopolitical dimensions. Since 1982 virtually all HICs have experienced low GDP growth, declining investment ratios and falling living standards that have rolled back much of the progress of previous decades. Per capita income in most HICs is lower today than in 1980, and absolute poverty and malnutrition are again reaching alarming levels. Even in 1988, when the HICs' real GDP growth reached 2 percent--compared with an average of 0.8 percent from 1980 to 1986--per capita income continued to decline. These circumstances explain why adjustment and economic reform have generally been fitful and uneven, and fraught with domestic social and political tensions.

Table 1: Highly Indebted Countries and the World Economy, 1980-88

	1980	1981	1982	1983	1984	1985	1986	1987	1988 <u>c/</u>
Percentage real change									
Economic Growth Indicators									
Industrial Country Output	1.3	2.0	-0.4	2.8	4.5	3.1	2.7	3.3	3.9
World Trade <u>a/</u>	1.3	2.4	-1.0	3.0	9.9	4.0	2.6	4.3	7.5
HIC GDP <u>b/</u>	5.6	0.6	-0.4	-2.9	1.9	3.7	3.4	1.7	2.0
HIC Investment <u>b/</u>	9.4	0.4	-13.1	-21.0	-2.1	4.5	1.9	0.8	-2.9
HIC Per Capita Consumption <u>b/</u>	3.4	0.3	-2.2	-4.1	-1.7	0.2	2.6	-1.4	-0.6
HIC Exports <u>b/</u>	1.1	-6.6	0.0	5.0	9.3	2.2	0.7	0.4	6.4
HIC Imports <u>b/</u>	8.2	2.3	-14.1	-20.4	-1.1	-1.6	4.0	-1.7	2.0
US\$ billion									
Total External Debt	289.0	351.0	391.0	422.0	438.0	454.0	482.0	527.0	529.0
Net Flows to HICs	28.6	43.7	34.6	19.1	13.3	6.0	4.5	6.2	7.6
Net Transfers to HICs <u>d/</u>	8.8	18.3	3.7	-9.9	-19.9	-26.5	-25.8	-21.8	-31.1

a/ Volume.

b/ Constant 1980 US dollars.

c/ Preliminary estimates.

d/ Net resource transfers are defined as the difference between new lending and total debt service (interest and principal repayments).

Source: World Debt Tables 1988-89

By comparison, expansion in the industrial countries is already in its sixth year--the longest period of uninterrupted peacetime growth. In 1988 that growth exceeded all expectations, accelerating to 3.9 percent. The undertone of world trade is equally buoyant with an estimated volume growth of about 7 percent in 1988.

The stark contrast of economic trends in industrial countries and HICs--rising prosperity in the former, falling living standards in the latter--underscores the impact of the debt crisis in debtor countries and points to shortcomings in the debt strategy that has evolved since 1982. It has been successful in preventing large-scale defaults and preserving the stability of the international financial system. But success has been one-sided as little has been done to accommodate the debtors' continuing financing needs. Three general observations come to mind.

- 0 Cuts in domestic absorption, declining investment ratios and forced austerity--all of which were necessary to maintain some degree of debt service in an environment of negative resource transfers--have delinked the HICs' growth from that in the industrial nations. From 1983 to 1988 the HICs' GDP grew by an average of only 1.8 percent, or about half that of industrial countries. This compares with growth rates in excess 6 percent, twice those of industrial countries, from 1970 to 1982. (see Table 1) Consistent strong growth in HICs during the decade preceding the debt crisis shows that the post-1974 commercial recycling of OPEC surpluses to developing countries had acted as a growth multiplier. That was even the case in countries that subsequently became problem debtors because they had failed to channel foreign borrowings into productive investments. Moreover, until 1981 low or negative real interest rates made it deceptively easy to service a rising external debt.
- 0 In contrast with their commercial creditors, the debtors have been unable--and generally reluctant--to form a cartel. Negotiations with foreign creditors have invariably involved one country at-a-time. Commercial banks, on the other hand, immediately formed strong coalitions to deal with problem debtors. Since 1983 all bank lending to HICs has been concerted and coordinated by bank advisory committees. ^{4/} Coordinated action has strengthened the creditors' bargaining position in debt rescheduling negotiations and kept new lending to the strict minimum required to refinance a portion of interest due and maintain loans in performing status. Most banks have also been able to accumulate large precautionary loss reserves, beyond those that had been mandated by regulators, and have trimmed their risk exposures in HICs.
- 0 Last, but not least, the unexpectedly strong performance of industrial countries in 1987 and 1988 does not mean that the recessionary phase of the current business cycle can be postponed indefinitely. Although that risk is slimmer now than in 1987, the global economy could still fall prey to a recession. In that case

^{4/} In their negotiations with debtors, the commercial banks are represented by an advisory committee that comprises the largest creditors. As these negotiations often take place in London, bank advisory committees are usually referred to as the "London Club".

the external environment for developing countries could be very similar to that which triggered the debt crisis of 1982: export volumes and revenues would fall, terms of trade worsen and real interest rates rise. Coming after several years of slow growth, such a situation could lead to the suspension of debt service by most HICs.

Concern about the economic decline of the HICs and about the risks their chronic debt overhang ^{5/} still poses to the international community has motivated several ambitious proposals that set out alternatives to the current market-based debt strategies. Several debt proposals reviewed in this paper argue that market-based formulas are inherently biased against the debtors and that the stability of the international financial system has been preserved at their expense. They point to the economic decline in HICs, where large negative resource transfers have caused hardship and contributed to the lack of adjustment. A number of proposals go further, and stress the need to defuse social and political tensions in debtor countries, especially in Latin America, where debt-related problems are increasingly threatening fragile democracies.

The focus on negative resource transfers is particularly justified when they occur after years of declining living standards or, as is the case of most HICs, before the basis for resumed growth has been established. Most debt proposals therefore seek to restore positive resource transfers to the debtor countries, but often differ in their individual approaches. Some proposals offer formulas to stimulate new lending; others advocate large-scale, unilateral debt forgiveness; others still seek to combine new lending and debt relief.

Following this introduction, Section 2 reviews how the debt strategy has evolved since the 1985 Baker initiative. Section 3 assesses the potential for a sustained expansion of market-based voluntary debt reduction. Section 4 provides a taxonomy of debt plans that propose alternatives to market-based approaches. Section 5 sets out basic criteria for the evaluation of the debt plans that are reviewed in the next section. Conclusions are presented in the last section.

^{5/} A debt overhang can be defined as a burden of external debt and debt service that reduces incentives to adjustment, and can, in fact, hinder the adjustment process.

II. The Evolution of Debt Workouts since the Baker Initiative

The Baker initiative of September 1985 formalized the consensus that the only way to resolve the HICs' debt overhang would be to combine adjustment with growth, rather than forced austerity. ^{6/} To promote both goals the initiative called for increased lending--in a total amount of \$29 billion--by commercial creditors and multilateral agencies, to be disbursed over the next three years.

It is now clear that the result of policies and programs based on that initiative is, at best, mixed. For many heavily indebted countries the outcome of the debt crisis remains as uncertain as in 1982, particularly in cases where the sheer size of debt service obligations continues to exceed the capacity--or willingness--to pay.

- 0 With hindsight, the initiative's targets for new lending were too modest. Moreover, actual new lending has failed to meet those targets. For instance, in 1988 new money commitments from commercial banks were still only a modest \$7.5 billion--including \$5.2 billion to Brazil--and covered only partial refinancing of interest due.
- 0 The HICs' debt burden has nevertheless continued to rise. In dollar equivalents, their total external debt has increased by 21 percent since 1985, reaching \$527 billion in 1988. Admittedly, given the large component of non-dollar debt, that increase is largely attributable to currency valuation effects resulting from the devaluation of the US dollar since early 1985. (One way of measuring the impact of currency valuation effects is to convert end-of-year dollar debt stocks into a composite currency unit, such as the SDRs. On that basis, the total external debt of HICs actually declined from SDR413 billion in 1985, to SDR392 billion in 1987.)
- 0 Excluding arrears, HICs have made debt service payments of \$146 billion--or more than 6 percent of their combined GNP--during the 1985-87 period, and their total net resource transfers ^{7/} to foreign long-term creditors reached \$74 billion (Figure 1).
- 0 Despite considerable efforts--including ill-fated "heterodox" stabilization programs in Brazil and Argentina (the "Cruzado" and "Austral" plans)--success in containing inflation and pursuing adjustment has been limited. Indeed, a number of Latin-American HICs still suffer from hyperinflation.

^{6/} The Baker Initiative singled out fifteen highly-indebted countries, "the Baker 15", for priority action. That group includes all HICs, except Jamaica and Costa Rica.

^{7/} Net resource transfers become negative when total debt service--principal repayments and interest payments--exceeds the amount of new lending.

- 0 In most HICs, gross investment remains well below the levels reached before the outbreak of the debt crisis. Preliminary estimates are that, in 1988, gross investment in those 17 countries was only about three quarters of the 1979-81 average. The reason for this is that the burden of net resource transfers to foreign creditors has fallen mainly on productive investment: the decrease in investment is roughly equal to the amount of net resource transfers. In other words, inadequate investment levels are, to a large degree, the result of declining support from commercial creditors. In addition, as insufficient investment prolongs the cycle of low growth, it creates a vicious circle where poor performance and low creditworthiness continue to discourage new lending.

Economic progress and adjustment in the HICs have also been hindered by an unfavorable trading environment and by recurring external shocks. Both factors have affected the debtors' export performance and ability to service debt:

- 0 The resurgence of protectionism in industrial countries, especially non-tariff barriers that have a strong bias against imports from developing countries, have hurt debtors that had to generate trade surpluses to service their debt.
- 0 Until 1987, weak or declining commodity prices continued to erode the terms of trade and export revenues of several HICs: the 1986 drop in oil prices was severely destabilizing for oil-producing countries, such as Ecuador, Mexico, Nigeria and Venezuela; the weakening price of tropical beverages was particularly harmful for countries like Côte d'Ivoire.
- 0 The initial impact of high real interest rates ^{8/} on external debt was compounded by currency valuation effects (the post-1984 devaluation of the US dollar) as the growth of export revenues (in dollars) lagged behind the rate of dollar debt accretion until 1987

The lack of tangible progress to-date can be measured from the trend for the two main indicators of relative debt burdens--the debt-service ratio and debt-export ratio. In 1988 the HICs had an average debt service ratio--based on total debt--of 35.5 percent, or only marginally below that of 38.8 percent in 1982 (Table 2). Admittedly, that debt ratio had dropped to below 31 percent in 1987. But, as debt service is measured on a cash basis, that improvement was mostly due to large interest arrears, notably by Brazil after its suspension of interest payments in February of that year. This also explains the apparent paradox that Brazil's payment of 1987 interest arrears in 1988 actually contributed to a worsening of the average debt-service ratio in that year.

^{8/} Using the export price cost deflator, real dollar interest rates have consistently exceeded 10 percent from 1980 through 1986.

The second measure of the HICs' continuing debt servicing problems is that the ratio of total debt to exports (their primary source of foreign exchange to service external debt) has risen by close to 40 percent, from 259 percent in 1982 to 357 percent in 1987. Although preliminary estimates are that that ratio dropped to 293 percent in 1988, that improvement reflects the impact of special factors.

- 0 The first factor is purely exogenous, namely the appreciation of the dollar during the first nine months of 1988. This has partly reversed the earlier effect of a weakening dollar and brought down the dollar value of debt denominated in other currencies.
- 0 As is discussed below, voluntary debt reduction by commercial creditors is gaining ground, and is slowing down the rate of debt accretion.
- 0 Considerable adjustment efforts, and diversification into non-traditional exports have enabled the two largest debtors, Brazil and Mexico, strongly to improve their export performance and revenues in 1987 and 1988. The size of both countries' debt and exports, relative to those of the other HICs, has lowered that group's combined debt-export ratio and hides the continued poor export performance of other countries.

However, the generally disappointing performance of HICs contrasts with the experience of other developing countries, in particular those in East Asia. Those countries were more successful in adjusting to the same unfavorable external environment and were able to raise export revenues and increase the purchasing power of their exports throughout the 1980s. Their greater adaptability to changing conditions in the world economy highlights the importance of flexible responses and sound economic policies.

Protracted uncertainty about the outcome of the debt crisis is reflected in average discounts of more than 50 percent in the secondary market for HIC debt. That uncertainty also explains why commercial creditors and the debtor countries continue to pursue diverging objectives in their debt negotiations. Whereas the debtors' usual goal is to obtain new credits and to "gain time", their creditors aim to keep debt service as current as possible and to trim risk exposures--in absolute terms and relative to share capital. Moreover, banks will remain unwilling to resume voluntary lending to problem debtors until stronger growth improves their perceived creditworthiness and translates into smaller discounts in the secondary loan market.

Table 2: Key Debt Indicators, 1985-88
(Percentage)

	<u>Debt Service Ratio</u> <u>a/</u>				<u>Debt-Export Ratio</u> <u>a/</u>			
	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u> <u>b/</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u> <u>b/</u>
Developing Countries	23.1	24.6	22.6	21.5	163.5	189.0	180.7	170.0
Low-Income Countries	12.7	14.8	14.0	14.5	156.7	177.1	182.1	180.0
Middle-Income Countries	24.8	26.3	24.5	23.0	164.5	190.8	182.2	175.0
Memorandum Items								
Sub-Saharan Africa	24.2	21.7	18.4	20.5	191.8	273.4	307.6	315.0
HICs	33.3	36.7	30.6	35.5	146.3	308.8	309.9	295.0

a/ Debt ratios are based on long-term debt and associated service payments (on a cash basis) and do not include short-term debt or arrears.

b/ Preliminary estimates.

Source: World Debt Tables 1988-89

The reason for this is obvious. Even the larger banks with long-term commitments to developing countries face difficult choices. On the one hand, their collective interest would be to step up "defensive" lending, provided a relaxation of the financing constraint in major debtors can stimulate investment and promote growth. This would lower the risk of future interruptions of debt service and improve the quality of existing loan assets. On the other hand, it is also in each bank's interest not to take the lead, as even the largest lenders could have only a marginal effect on total resource flows to any given HIC. The implicit value any new loan would therefore immediately fall to the level of prevailing secondary-market prices. That situation replicates the "no collusion" prisoners' dilemma.

That dilemma is reinforced by the gradual erosion of the banks' consensus in support of a concerted strategy. The banks' business strategies vis-a-vis HICs now vary widely, depending on relative exposure levels, the ability to accumulate sufficient loss provisions and opportunities to diversify activities in the global financial market. Creditor attitudes are also influenced by national regulatory and tax regimes that govern the tax and capitalization status of loan loss provisions.

These considerations have reduced the number of active creditors. By and large, only major international banks with multinational corporate clients

and branch or subsidiary networks in HICs remain willing to preserve long-term commercial relations with them and are now virtually their sole source of trade finance and other forms of short-term credit. To keep existing loans in a performing status these larger creditors explore innovative market-based debt workouts, including voluntary debt reduction in selected countries. Smaller, less exposed banks are less accommodating. During the heyday of commercial lending to developing countries these banks, including several US regionals, had built up LDC loan portfolios by participating in international syndicates arranged by their larger counterparts. After 1982, these second-string lenders became reluctant to participate in debt reschedulings, expecting to be repaid out of the proceeds of the others banks' new loans. That attitude became known as "free riding". Now most small banks put a priority on winding down their HIC loan portfolios, even at the cost of substantial write-offs. The easiest way out for them is to accept "exit" bonds whenever there are reschedulings. ^{9/} —

The divergence of the banks' and the debtors' goals, and the lack of sufficient financing has also generated considerable tensions, especially in countries that already face strong internal political and social opposition to taxing adjustment and austerity. A clear illustration is provided by Latin American debtors whose commitment to such programs is occasionally flagging under the pressure of mounting domestic opposition. Moreover, as the debt problem becomes increasingly politicized, tensions can escalate to the point of provoking confrontational attitudes towards commercial creditors. These can take the form of protracted payment arrears and occasional interruptions of debt service. Peru's decision in 1985 to limit debt service to 10 percent of export revenues, and Brazil's suspension, in February 1987, of the service of its medium and long-term commercial debt are two good examples.

Despite this generally somber assessment, developments in 1988 pointed to, at least temporary, improvement. First, there was a return to more conciliatory attitudes between debtors and creditors. In November of that year Brazil was able to obtain a substantial financing package from its commercial creditors, ended the moratorium on interest payments that had been declared in early 1987, and cleared its interest arrears to commercial banks. There was also expectation of progress in Peru and Argentina, even though severe problems continue to affect their near-term prospects. Peru has adopted a set of austerity measures and is gradually resuming negotiations with its creditors to find ways to settle arrears. Argentina has started to settle some of its interest arrears and has begun discussions with the IMF and commercial banks on an economic adjustment program.

^{9/} Exit bonds are one of the menu options that aims to deal with free riding. These bonds are normally long-term and carry below-market yields. To compensate for that sacrifice, these bonds are excluded from the base for future concerted lending. For the remaining creditors this offers the prospect of more expeditious future negotiations, albeit at the cost of potentially larger lending commitments. To the debtors exit bonds offer low-cost, long-term rescheduling of part of their external liabilities.

Secondly large commercial creditors increasingly promote debt conversion and voluntary debt reduction (VDR). As a large part of VDR is transacted in the secondary market for loans, turnover in that market has risen substantially. For 1988 as a whole, total turnover, including interbank trading, is estimated at around \$36 billion. VDR clauses have also been included in recent agreements between Bolivia, Brazil, Chile, and Mexico and their commercial creditors. The growing volume of VDR, through debt-equity swaps and debt repurchases has enabled a number of debtors to capture some of the secondary loan market's discounts.

Nevertheless, activity remains concentrated in the debts of Argentina, Brazil, Chile and Mexico. These four countries account for 90 percent of all secondary-market transactions and debt conversion to-date. For the other debtors the asymmetry the between heavily-discounted secondary-market prices for their debt and the contractual value of their debt-service obligations remains an aggravating fact as they have generally been unable to take advantage of prevailing discounts. The reason for this is that a debtor's unilateral repurchase of part of its debt (a "buyback") is the legal equivalent of prepayment. "Sharing provisions" that are customary in loan agreements usually prevent such buybacks. ^{10/} This explains why market discounts can generally only be passed through to debtors in the context of debt-reduction transactions that are structured to deal with legal problems, such as those that arise from sharing clauses.

Further headway with VDR may broaden the emerging consensus that debt reduction need not prevent future commercial lending if it can be explicitly linked to the borrowers' adjustment efforts and economic performance. As discussed in the 1988-89 edition of the World Debt Tables, this could set the stage for a more pragmatic debt strategy that blends greater use of VDR by commercial banks, renewed adjustment efforts by debtor countries, and an enhanced catalytic role of the multilateral financial institutions.

To be successful, such a strategy would need to have a demonstrable impact on the level of negative resource transfers by the HICs and translate into higher investment levels. Otherwise it would merely "buy time" and ultimately raise the geopolitical dimensions of the debt crisis.

III. Can VDR Be Expanded Sufficiently to Offset the Shortfall in Lending

The recent surge in the volume of VDR has made it a central tenet of the evolving debt strategy. To evaluate the potential of sustained expansion in the volume of market-based debt reduction, to the point that it can have a major impact on resource transfers, a number of factors have to be taken into account.

^{10/} Sharing provisions specify that any prepayment of part of a syndicated loan to any member(s) of the syndicate has to be "shared" with the other creditors in that syndicate, unless they have waived their right to share.

First of all, VDR operations are complex, because they usually involve an exchange of assets between a debtor and participating creditors. This means that each party should attach a greater value to the asset it is receiving, than to that it is surrendering. Thus, if as is normally the case, VDR involves a financial sacrifice, such as a lower contractual value of the assets that substitute the creditors' original debt claims, those new assets should be in a better risk category. For example, if a loan is exchanged at a discount for negotiable securities--as was the case in Mexico's debt exchange of February 1988--the new securities should have a greater probability of repayment than the original loan. Obviously, if loans are repurchased for cash--as in Bolivia's 1988 debt buyback ^{11/}--the risk-free nature of cash can make creditors more willing to consider larger discounts.

Reciprocally, debtors should feel that they can exchange or repurchase debt for less than its implicit value. This implies an asymmetry between the creditors' subjective risk evaluation of the original asset and the debtors' ability (or willingness) to honor future debt-service obligations. That asymmetry can prompt debtors to enhance the perceived value of the new asset, so as to make the exchange attractive to creditors. Mexico could do so by offering US Treasury zero-coupon bonds as collateral. But other HICs may lack the reserve cushion to purchase such sweeteners, which limits their room for maneuver.

A further difficulty stems from the fact that most debt-reduction agreements involve three sets of parties: the debtor; creditors that are willing to reduce the debt voluntarily; and non-participating creditors. In those settings non-participants have de facto veto power if there is a need to amend provisions--such as sharing provisions and negative pledge clauses--in loan agreements to which they were party. Thus, absent the non-participants' consent to waive those provisions, VDR cannot proceed.

Debt-equity swaps--one of the main vehicles for VDR--also raise a number of issues that could limit the spread of that formula.

- 0 The domestic monetization of foreign debt--a potential host country has to provide local currency in order to make the debt swap possible--tends to increase the domestic money supply. Unless these monetary effects are sterilized--for instance, by the issuance of government bonds--they can further exacerbate inflationary pressures. These considerations have prompted Mexico to suspend and Brazil to interrupt their respective debt-swap programs (Brazil resumed debt-equity swaps in early 1989).

^{11/} Bolivia's debt buyback covered \$335 million of commercial debt (40 percent of the total thereof). It was funded by donor governments in industrial countries, partly appropriating ODA funds that had been earmarked for Bolivia. In this case banks accepted an average discount of 89 percent.

- 0 If debt-equity swaps are substitutes for foreign direct investment (FDI) that would have taken place anyway, they subsidize those investments, may flaw the allocation of resources and amount to the loss of a genuine inflow of foreign exchange. In addition, profit remittances to foreign investors may eventually create outward resource transfers that could exceed those on debt service.
- 0 Increased foreign ownership and control of particular sectors of the economy due to debt-equity swaps can heighten domestic political sensitivities.
- 0 Any form of debt reduction, including VDR, can create perverse incentives--the so-called "moral hazard"--for debtors to manipulate market conditions, so that greater discounts help maximize their gains in a prospective transaction. As is discussed later, formal debt relief proposals are better equipped to deal with it than that problem.

Finally, significant increases in the volume of VDR are likely to require legislative and regulatory action in industrial and developing countries, and more streamlined negotiation techniques. The last point may be the easiest, as greater experience and standardized legal documentation are likely to bring about the needed flexibility.

Legislative action will be more complex. Useful measures to be adopted by industrial countries would include changes in the definition of the banks' regulatory capital, and greater uniformity of the tax and accounting treatment of loan loss provisions. Such steps could make VDR financially attractive to a wider group of banks. For example, commercial banks may be more willing to accept sizeable book losses on VDR--in line with existing loan-loss provisions--if their regulatory capital are not affected by the corresponding writeoffs.

One approach^{12/} that would be particularly beneficial to undercapitalized banks^{12/} would be to permit them to spread their book losses over time. An alternative would be to enable banks to offset a part of their writeoffs on VDR with the market value of foreign assets (investments) acquired through debt-equity swaps. Greater uniformity in national tax and

^{12/} The gradual introduction of uniform minimum standard capital ratios by 1992--as agreed by the Basle Supervisors' Committee (the Cooke Committee, under the auspices of the B.I.S)--is likely to influence the banks' lending behavior and ability to incur book losses on VDR-linked asset conversions. Capital-constrained banks--such as several among the U.S. money-center banks--that expect difficulties in meeting the 1992 target capital-asset ratio of 8 percent, may be unable to absorb large writeoffs on VDR. Instead, they may favor to carry as long as possible general, unallocated loan-loss provisions. (In the U.S. and a number of other countries, these provisions are currently counted as regulatory

accounting regimes that govern the valuation of bank assets and the treatment of existing loan loss provisions would play an equally important role. By establishing a "level playing field" for creditors in different countries, it would increase the number of banks that are willing to participate in VDR.

Legislation in the debtor countries, designed to facilitate debt-equity swaps would have to complement action by the industrial countries. For example, countries that wish to promote such swaps would have to lift possible restrictions on the foreign ownership or control of domestic enterprises. Appropriate measures may also be needed to regulate the repatriation of investment revenues, and to create a framework for debt auctions. The introduction of investment codes or privatization programs, to encourage private-sector investment, would be equally important.

IV. A Taxonomy of Debt Proposals

Close to seventy different debt plans have been formulated during the last five years^{13/}. A common thread among them is the perception that existing debt-workouts can, at best, maintain a fragile status quo between creditors and debtors, but cannot regenerate income growth in the latter. Most debt plans therefore seek to create a less constraining financial environment for highly-indebted countries, in order to restore solvency or, as the case may be, liquidity. In most cases, the secondary aim is to generate positive externalities for the debtors, their creditors and the global economy. The scope of these benefits is considerable: increased resource flows, supported by appropriate economic and institutional reforms and higher domestic absorption, could induce a virtuous circle of higher growth in HICs, help alleviate the plight of their poor, and generate export opportunities for industrial countries. Moreover, as the debtors' creditworthiness improves, the international financial system would become more stable as the threat of further interruptions in the debt service recedes.

To achieve their respective goals, debt proposals either recommend frameworks designed to stimulate new lending, to provide large-scale debt relief, or to combine both. The more ambitious proposals would make debt relief by commercial creditors quasi-compulsory by offering incentives to participate and imposing penalties on non-participants.

How to classify debt proposals

Given the multiplicity of proposals that vary in purpose, scope and structure, a taxonomy is a useful guide to analysis. Classification criteria can obviously be chosen to suit different types of analyses. For example, a legal analysis of debt plans may use as primary distinction whether ownership of risk assets remains with the original creditors or is transferred to another entity such as an International Debt Facility. However, by putting debt-equity swaps and debt purchases by an IDF under the same heading, that classification would not be suitable to determine the comparative advantages of either legal structure to deal with specific types of debt overhang.

One difficulty is that some criteria can generate classifications of doubtful operational relevance. For instance, to rank proposals by their principal beneficiaries would fail to highlight the mutuality of interests among interdependent debtors and creditors. Lower debt burdens, whether as a result of concessional interest rates or of debt forgiveness, are likely to improve a debtor's ability to service the remaining debt. All else being equal, this would also raise the quality--and secondary-market price--of the banks' remaining risk assets in that country.

capital.)

^{13/} Several proposals date back to 1983, when the financial markets still

This paper starts from a primary distinction between cases of "mild" debt overhang (debtor illiquidity) and "severe" debt overhang (insolvency) ^{14/} and ranks debt proposals by their ability and effectiveness in dealing with either type of debt overhang. That approach is normative to the extent it considers that new commercial lending at market terms could prove harmful in cases of severe debt overhang, and that debt relief may not be justifiable for countries with mild debt overhangs. In line with that approach, proposals are listed under the two main headings of new money and debt relief.

New money plans are specifically designed to restore liquidity in debtor countries. Subject to the qualifications that are made in the next section, new money is therefore likely to be of doubtful merit in cases of severe debt overhang. However, countries that fall into that category would be candidates for plans that seek to restore solvency through debt reduction and forgiveness.

Some additional caveats are needed.

- 0 Several plans, especially those that advocate extensive debt relief, seek "global" solutions and generalize their implicit or explicit analytical premises--illiquidity or insolvency--to all problem debtors without distinction. This overlooks the fact that, despite many shared problems, the HICs form a highly diversified group. Socio-economic conditions, near-term prospects and vulnerability to changes in the external environment differ widely among the HICs. For example, a drop in oil prices harms major oil exporters such as Nigeria or Mexico, but helps oil-importing countries like Brazil, Chile and the Philippines.
- 0 Global proposals to step up lending or reduce debt stocks without regard to the countries' individual circumstances, could also lack effectiveness in attempting to solve problems with the wrong tool--such as more lending to insolvent countries--and make it improbable that consensus can be reached among constituencies with diverging interests.
- 0 Certain proposals fall in the hybrid category of "debt stabilization" Debt stabilization can help debtors with mild overhangs to accommodate larger debt levels and is, therefore, a de facto subset of new money. But it can also be structured to reduce the burden of debt service and become a channel for debt relief in cases of severe debt problems. For reasons of convenience this taxonomy treats debt stabilization plans as a subset of new money plans.

expected that an orderly resolution of the debt crisis.

^{14/} For a technical definition types of debt types overhang, see I.Diwan and S. Claessens; Conditionality and Debt Relief, unpublished conference

- 0 Finally, as debt problems and the global conjuncture have evolved since 1982, some of the earlier proposals have become obsolete.

New money plans

These plans aim to restore liquidity in problem debtors with new lending. They include three main sub-categories:

- 0 Pure new lending plans that seek larger volumes of bilateral and/or multilateral official lending or, as in the case of the Baker Initiative, recommend a combination of private and multilateral lending. Proposals to increase official lending unilaterally often emanate from governments in capital exporting countries. Their adoption would require legislative action for the appropriation of the necessary funds.
- 0 Credit-enhancement plans that seek to generate larger lending flows by promoting the banks' collective interest in new lending by lowering the risk on new loans. This involves third-party guarantees that could be provided by one of the multilateral agencies, by industrial countries or by a new international guarantee agency.
- 0 Debt stabilization plans that adopt a more roundabout approach. Starting from the fact that a country's ability to service debt is as much a function of the predictability of the cost of external debt and of the external environment--for example, the occurrence of external trade shocks--as of the level of indebtedness itself, debt stabilization aims to mitigate the impact of exogenous events on debt servicing capacity. Financial engineering techniques such as interest-rate swaps and interest-rate caps can be used to stabilize debt costs. This distinguishes it from plans that focus on the external trading environment and advocate wider use of commodity stabilization techniques. The latter are not reviewed in this paper.

Debt reduction and debt relief plans

Debt relief is explicitly aimed at countries that are overindebted, and where additional lending would make debt service even more burdensome. These proposals therefore recommend that, in such cases, the countries' debt burden be alleviated. Under most formulations, concessions to the debtors would require the appropriation of public funds in industrial countries. Several proposals in this category also involve complex institutional arrangements, such as the creation of an international debt facility.

- o Proposals to lower the cost of debt aim to bring down interest rates below risk-adjusted market levels or to forgive a part of the interest due, for instance with extended grace periods during which interest payments would be limited to a fixed proportion of the debtor's export revenues. In either case the contractual amount of the principal due remains unchanged, but lower interest payments reduce the discounted present value of total debt-service.

- o **Proposals to lower debt stocks** seek to adjust indebtedness to the debtors' estimated capacity to pay. Contrary to VDR that is negotiated and depends on market opportunities such as attractive debt-equity swaps, these proposals advocate unrequited, often involuntary, debt forgiveness. In most formulations this would involve the creation of an International Debt Facility (IDF), or comparable agency, that would purchase commercial loans at a discount that is passed through to the debtors.

Both types of debt relief face an obvious difficulty: although lower debt service may be necessary for some countries, concessions should not be permanent or unconditional. Debt relief by itself cannot regenerate the necessary investment and the growth momentum: there needs to be assurance that resources released from debt service are channelled into productive investment. In other words, countries that seek to obtain debt relief also need sound economic policies to support productive investment.

V. Technical and Operational Aspects of Non-Market Debt Proposals

Besides the theoretical distinction between mild and severe overhang, which would serve to determine potential eligibility to new money and debt relief plans respectively, the implementation of most proposals would raise a number of technical and operational issues.

Criteria for the applicability of new money plans

Raising the level of net lending is the most obvious means to curb the savings drain in the debtor countries. Depending on the amount of new lending a given plan could stimulate, its impact on the magnitude and direction of net resource transfers could be substantial. As a general rule, all types of new money plans, whether direct or by means of credit enhancement and debt stabilization, are more likely to create a virtuous circle of investment and growth in countries with credible commitments to reform, prudent macro-economic policies, and a satisfactory debt service record. Applying the same principles, there are no a priori grounds to extend debt relief mechanisms, beyond VDR and reschedulings, to those countries.

New lending

It is necessary to make a clear distinction between the effects of increased official and commercial lending. Commercial loans at market terms tend to be more expensive and to have shorter maturities than those from official sources. By contrast, long-term official bilateral and multilateral lending can be tailored to the maturity profile of a country's debt outstanding, so as to ensure a more even debt repayment reschedule. Loans from multilateral agencies also carry strict conditionality. Their structural and sectoral adjustment loans (SALs and SEALs) in particular are designed to promote adjustment in the debtor countries.

Every effort is, therefore, justified to maintain or increase official lending flows to the weaker borrowers with severe debt overhangs, provided they are current in their debt service to those creditors and remain committed to necessary adjustment. Official lending is also compatible with VDR and more formal debt relief techniques.

Credit enhancement

For any given stock of debt, the real cost and/or the amount of principal due can fluctuate as a result of exogenous factors. A conventional method to calculate a country's real borrowing cost is to deflate nominal interest rates by the country's export-price index. ^{15/} Thus, if that index

paper. in

^{15/} This starts from the premise that export revenues are the only source of

drops, the real cost of debt rises. Similarly, the relative size of debt stocks comprised of various currencies is affected by valuation effects associated with the variability of cross-exchange rates of those currencies.^{16/} Illiquidity occurs when actual debt-service payments due temporarily exceed a debtor's debt-servicing capability.

Guarantees of debt-service obligations by creditworthy third parties remove the uncertainties posed to lenders by a debtor's potential illiquidity, but do not address the external factors that could cause it. Aside from eligibility criteria--as stated earlier, guarantees that encourage new lending are not advisable for insolvent countries--a number of considerations dictate that credit enhancement follows strict pricing rules and not be used indiscriminately.

- 0 Given that risk-adjusted spreads on guaranteed loans are lower than those that apply to the (unguaranteed) borrower, guarantee fees should be priced correctly. This means that the total cost of funds--including fees--does not exceed that of unguaranteed borrowings. Pricing should also be commensurate with the guarantor's risk on the loans, rather than be undifferentiated, so as to avoid "negative selection" whereby only the least creditworthy debtors seek coverage.
- 0 There should be a degree of burden sharing between lenders and guarantors, to limit the latter's risk and preserve the lenders' involvement in the debtor countries. It can be achieved through partial coverage, for instance on principal only. Creditors would still carry the risk of non payment of interest, but the risk-free principal would be protected against further writeoffs in the event of non-payment. Partial coverage also ensures maximum leverage of scarce guarantees.
- 0 Guarantees should be used selectively to enhance access to voluntary, rather than concerted lending. This makes it preferable to reserve them to borrowers that have moved beyond the debt restructuring phase.
- 0 As a rule, guarantees are preferable to collateral security in the form of asset pledges. Given the prevalence of negative pledge clauses in most loan agreements, asset pledges can be cumbersome as they would require waivers from all existing unprotected

foreign exchange to service external debt. An alternative method to compute real costs is to use an import-price deflator, on the assumption that monies borrowed are used to finance imports.

^{16/} In 1987 the total long-term debt of the developing countries increased by \$102.5 billion in nominal terms. However, of that amount \$74.5 billion (or 73 percent of the total) was directly attributable to currency valuation effects, associated with the strong depreciation of the US

creditors. ^{17/} In addition, collateral may have to be purchased by debtors and use up precious foreign exchange reserves. This discriminates against debtors that have insufficient reserves.

Debt stabilization

An alternative to protecting creditors against the potential interruption of debt service is to safeguard the debtors against the impact of future volatility in the external environment on their debt servicing obligations. From the creditors' point of view this type of protection is indirect: although a more predictable debt profile is likely to improve a debtor's ability to service debt, it cannot ensure willingness to do so. Debt stabilization techniques could therefore be less effective than guarantees as a catalyst for resumed voluntary commercial lending. On the other hand, the protection these techniques offer may be welcome for borrowers as it would dilute the effects of exogenous shocks on adjustment.

Protection against changes in the external environment falls into three categories:

lowering the interest-rate sensitivity of debt outstanding;

limiting the impact of currency valuation effects on debt stocks, and ensuring greater consistency between the currency mix of debt service and that of foreign trade earnings;

stabilizing export commodity prices to limit the variability of export receipts and of the export-adjusted real cost of debt.

a. Limiting the interest-rate sensitivity of debt

By far the largest part of the HICs' commercial debt is at floating rates. Three- and six-month dollar LIBOR is the most widely used pricing benchmark. Unforeseeable shifts in the level of that benchmark--from an average of about 11 in 1979, to more than 19 percent in 1980--set the stage for the 1982 debt crisis. It follows that, if the debtors can be protected against interest-rate shocks, the future value of the total debt service would be more predictable and sustainable. This, in turn, may be a catalyst for new lending.

dollar during the same year.

^{17/} Negative pledges specify that all creditors shall be treated equally. Therefore, if existing creditors are uncollateralized, there is a pledge not to offer collateral to other creditors, unless prior creditors are treated equally (*pari passu*). For example, in the case of Mexico's collateralized debt buyback of 1988, non-participating creditors, including the World Bank, had to waive the *pari passu* clause. By contrast, in a pure, uncollateralized guarantee, a third party assumes--for a fee--the commercial risk of nonpayment by the primary obligor. this

Aside from borrowing at fixed rates--a market segment that is seldom open to developing countries--the most effective protection against the variability of nominal interest rates is to use risk transformation and hedging techniques that lower the interest-rate sensitivity of debt.

Risk transformation involves interest-rate swaps that can be used to transform floating-rate liabilities into fixed-rate debt. Such swaps are actively traded in financial markets. An interest-rate swap agreement commits two parties to exchanging responsibility for all interest payments on specific liabilities. Thus, to obtain the desired protection, a debtor country would have to service a counterparty's fixed-rate debt, in exchange for that party's commitment to service the country's floating-rate debt of equal amount, maturity and currency.

As there is no exchange of principal amounts, the only risk for each party to the swap agreement is that the other party could default on its interest payments. That risk varies over time, depending on interest-rate movements. For example, the risk to the floating-rate payer (in this case a developing country's partner in the swap) increases whenever short-term rates fall. Lesser-rated parties, including most developing countries, are therefore normally required to provide performance guarantees by a more creditworthy third party.

One indirect benefit is that performance guarantees reduce the swap's implicit cost (the difference in the internal rate of return of the floating-rate and fixed-rate cash flows that are being exchanged). This suggests that the pricing and selectivity criteria that were set out for credit enhancement should also apply to these more limited swap performance guarantees.

Interest-rate caps that set a ceiling on interest-rate levels are alternative forms of protection. Like swaps, rate caps are traded in financial markets. Their purchase involves lump-sum payments to the provider of the cap, equal to the discounted value of the risk that market rates will exceed the cap over the life of the agreement.^{18/} This is a clear drawback for developing countries with limited foreign exchange resources. However, the cost of caps can be lowered if a debtor is willing to accept more limited protection. A possible structure is to capitalize interest in excess of a given ceiling. As is described in the next section, this more complex formula would require the intervention of a central clearing agency.

Finally, as an alternative to interest swaps and caps, debtors can hedge interest-rate risks with options and futures. Both instruments are described below in the context of currency hedging, which follows the basic principles of interest-rate hedging.

requires no waiver from existing, inguaranteed creditors.

^{18/} This explains why the pricing of caps is a function of the period over which they run and of expected interest-rate trends. The greater the probability expected probability that interest rates will rise, the higher

b. Limiting the debtors' foreign-exchange risks and exposure

Risk of loss or of opportunities foregone is inherent in any financial decision, including that of borrowing in one currency rather than another. The choice of loan currencies is seldom left to borrowers. Although the US dollar is the most common vehicle for syndicated lending, in recent years non-US commercial banks and export credit agencies have increasingly chosen to lend in their own currencies. This can create a currency risk for debtors whose foreign trade earnings are predominantly in US dollars. In addition, as mentioned earlier, in periods of dollar weakness, non-dollar debt inflates the dollar value of debt stocks and debt service.

Both risks--valuation effects and currency mismatches with foreign trade revenue--can be hedged. In its simplest form a currency hedge offers protection against potential losses due to exchange-rate fluctuations. For instance, if a foreign currency is to be received in the future as settlement of a sale of goods and services, that currency can be sold in the forward market before it is actually received. A forward sale at today's price protects, or "covers", the creditor against the risk of devaluation of a currency that may be needed later for debt service. But the trade-off of a forward sale is that any gain on the potential appreciation of the same currency is automatically foregone.

In the rapidly changing international financial markets currency options and futures are now used and offer more flexible hedges of foreign-exchange risks and exposures.^{19/} Futures markets are distinct from cash markets. In the latter any transaction is settled in full, at the time of the transaction. By contrast, contract sizes and settlement dates for financial futures are standardized, they are traded in specialized markets and only small margin deposits are required prior to settlement. This means that relatively small cash investments can be highly leveraged.

the cost of the cap.

^{19/} The theory of options and futures is extremely complex. Both techniques are designed to minimize downside risks without foregoing opportunities of future gain. This explains why a "good" hedge--there are no perfect hedges--has to share the financial characteristics of the asset it protects, have a predictable price pattern that is the reciprocal to that of the primary asset (or liability) and involve a minimal cash investment. Taking the example of hedging currency risks on debt with options or futures, the cash transaction (the borrowing in a currency such as yen the debtor does not wish to hold) can be hedged by the purchase of an option or future on that currency. Any future loss arising from an appreciation of that currency (debt service in appreciated yens, while export receipts are in dollars) will be partly compensated by the ability to take delivery of that currency at a price agreed before its appreciation. Both tools can also be used to hedge the disposal of a cash asset (such as a country's secondary reserves) to generate liquid funds. If the price of that asset (for example, US Treasury bonds) is expected to rise after its sale, an option or future on the same asset can be bought to capture that

Financial options are distinct from futures, but have many similarities with them. An option is a contract between two parties--the seller, or 'writer' of the option, and the buyer--that gives the right, but not the obligation, to either to sell (put options) or buy (call options) a specific financial asset such as a given amount of foreign currency or an interest-bearing instrument.^{20/} That asset, which is seldom delivered, serves to hedge a cash asset. The similarity with futures markets is that the purchase of options also involves relatively small margin deposits.

Given their complexity, these financial tools are usually impractical for all but a handful of countries with sophisticated debt management strategies. Options, in particular, are speculative and carry a substantial risk of financial loss. By contrast, currency swaps are more practical--and less risky--hedging tools. Their structure is quite simple and involves the spot sale of the currency the borrower wishes to relinquish and a matching long-term forward repurchase of the same currency. When swaps are used to hedge the currency risk on a borrowing, their maturity (i.e. the date of the long forward repurchase) can be timed to coincide with that of the borrowing itself, so that the original currency is available for the principal repayment. Like interest-rate swaps, currency swaps entail a performance risk. Moreover, as the latter swaps involve an exchange of principal, the counterparty's risk, hence the desired performance guarantee, is larger and more costly. This is likely to restrict the use of currency swaps to the more creditworthy developing countries.

Debt relief and debt reduction

Advocates of broad based debt relief argue that where commitment to adjustment and reform is patchy and compounded by actual or de facto insolvency, debt accretion is most likely to refinance maturing obligations and usually translates into higher, even less sustainable debt ratios, that exacerbate insolvency. Thus, for countries in this category, new lending may prove counterproductive unless it follows the general criteria and conditions used by multilateral agencies.

The rationale for debt relief is that a severe debt overhang is an obstacle to--and often a disincentive for--successful adjustment. This suggests that in countries with strong debt overhangs and uncertain commitments to adjustment, debt relief with appropriate conditionality and surveillance would ensure that necessary reforms are introduced and that the savings generated by lower debt service are channelled into productive investments. This would enable them to expand production and resume growth at a lower level of indebtedness. Once sufficient growth is achieved, debt ratios would fall further still, which would subsequently pave the way for the

potential gain.

^{20/} Commodity and stock options and futures follow the same general

more conventional pattern of new borrowings, after creditworthiness is improved. The more comprehensive debt proposals that aim to combine debt reduction with new lending adhere to the same principles.

As was argued in the 1988-89 edition of the World Debt Tables, the main advantage of a properly structured debt relief plan is that it can provide a solution to free riding by smaller creditors.^{21/} For example, some proposals include a combination of incentives to participate and deterrents to minimize free riding (non participation): the so-called "carrots and sticks" approach. Carrots can include more favorable risk weighting of the remaining loans--after debt reduction--to the same debtors, on the presumption that lower debt stocks will increase the countries' ability to service them, and thus improve the quality of those loans.^{22/} An alternative is to enable banks to spread the amortization of write-offs over time, so as to reduce the immediate impact on their capital and maximize tax benefits. One of the most standard sticks to deter free riders is the obligation for non-participants to mark down their loan assets to the level of discounts agreed by the participating creditors and to absorb that financial loss in the first year. The introduction of such sanctions would require the cooperation of bank regulators.

The advantage of offering a potential solution to free riding could nevertheless be offset by other legal, operational and financial considerations that are basic obstacles to the implementation of debt relief proposals.

- 0 Debt forgiveness is exposed to moral hazard by the debtors. If, as is suggested in many proposals, an IDF were to purchase the banks' claims at discounts that are a function of prices in the secondary loan market, the debtors' gains would be commensurate to the depth of the discount. This could create an incentive to manipulate market conditions with threats to suspend debt service. As discounts in the secondary loan market deepen in response to such threats, the debtors would benefit from any subsequent debt repurchase at lower prices. Potential moral hazard can be minimized by delinking the IDF's purchase price from market discounts and by imposing strict conditionality as an eligibility criterion for debt relief.^{23/}

principles, but are not relevant in this context.

21/ Free riding is generally difficult to avoid in market-based menu options and debt reschedulings, given that national legal systems protect banks against coercion. However, in September 1988 a provisional agreement to reschedule debt for Côte d'Ivoire attempted to deal with this problem. The agreement, which is not yet effective, would ensure that free riders do not receive interest payments from new resources made available by the participating banks.

22/ Under the Basle Committee guidelines loans to non-OECD countries will be weighted at 100 percent of face value.

- 0 A further complication is that commercial creditors could benefit financially from the introduction of a debt relief plan. This has led some to argue that such schemes would amount to a bank bailout. For example, several recent studies have shown that the launching of a major debt initiative would raise secondary-market prices on the assumption that relief would improve the probability that the remaining debt will be serviced. If, as may be required to minimize moral hazard by the debtors, the IDF were to repurchase debt at those higher market prices, the banks could benefit in three ways: lower discounts on loan sales would contain book losses; the quality and market price of their remaining loan assets would improve; credit risk of a part of their portfolio would be transferred to the IDF. Such gains could be lowered by relating the IDF's purchase price to the original, pre-IDF market discounts.^{24/}
- 0 A related consideration is that if debt relief were provided by a publicly-funded international debt agency that repurchases commercial loans, a large number of private creditors would be able to transfer risk assets to a single public sector agency. Once ownership of the loans had been transferred to the IDF--in exchange for its own debt securities--it would bear the full risk of nonpayment by the debtors. That socialization of risks would run counter to market practice and may be difficult to justify.
- 0 By contrast, if commercial banks were virtually forced to sell a substantial portion of their claims on developing countries at large discounts, their book losses could exceed those that have so far been associated with VDR. For the less provisioned banks such losses could exceed existing provisions and, in extreme cases, substantially erode regulatory capital. The banks could also argue that official creditors should share these losses. The HICs owe more than \$127 billion to official creditors, including \$66 billion in liabilities to, or guaranteed by industrial country governments. Commercial banks would naturally be loath to accept unilateral losses that improve the value of official claims on the same creditors.
- 0 Last, but not least, the creation of a new international debt agency would almost certainly involve substantial financial costs for the governments in industrial countries that fund the agency and underwrite its commitments. The initial capitalization would require large injections of public funds. Moreover, the agency would be exposed to the risk of nonpayment of loans it had acquired from commercial creditors. Commitment to underwrite these potential losses would require additional budgetary allocations.

^{23/} Corden, W. Max, An International Debt Facility?, IMF Working Paper, 2/12/88, p. 11.

This last point is crucial, as it may be impossible to reach political consensus on these budgetary implications in the present environment of resource constraints and fiscal austerity in several industrial countries. However, one could argue that the unconditional commercial recycling of OPEC's surpluses to developing countries during the 1970s had been actively encouraged.^{25/} By stimulating import-led growth in the debtor countries that recycling generated exports to developing countries, which dampened the recessionary impact of the first oil shock in industrial countries. In that sense, any use of public monies to alleviate severe debt overhangs would be the deferred cost of those past economic benefits.

The implementation of debt relief schemes would also raise a number of operational issues.

- 0 How much debt relief should be provided? A possible criterion is to set debt relief at a level that would bring the debt-service ratio (or interest ratio) within the "safety range". However, that range can be subjective and varies from country to country: at a given debt-service ratio, say 25 percent, certain countries may experience problems, others not. In other words, capacity to pay can only be determined on a case-by-case basis. An alternative, as proposed by UNCTAD in 1988 (see below) is to grant across-the-board debt relief in a certain amount (in UNCTAD's proposal, 30 percent of the HICs' commercial debt). The disadvantages of the latter approach are that it fails to differentiate among borrowers and that the writeoffs commercial banks would have to make could exceed the level of provisioning of the less protected banks.
- 0 What would be the institutional relationship between a new international debt facility and the existing multilateral agencies? For example, the IDF could be set up as a separate entity that cooperates with the multilaterals to determine eligibility of individual countries and the amount of relief to be granted to each. It would also have to liaise with the multilaterals to establish appropriate conditionality and surveillance procedures for the countries that had received debt relief. Alternatively, as is recommended by a number of proposals, the IDF could be set up as a joint subsidiary of the IBRD and IMF to minimize coordination problems.
- 0 Should relief take the form of interest concessions or partial debt reduction? Two reasons argue in favor of choosing the former method. First, the extended grace periods of recent reschedulings would initially limit the cash-flow effect of debt reduction to interest savings on the principal forgiven, but would have little

24/ Ibid.

25/ Lever & Huhme, Debt and Danger, The World Financial Crisis, Penguin Books

impact on principal repayments that had been deferred by the rescheduling. To grant debt reduction under such circumstances would create an asymmetry between the debtors' limited gains and the creditors' substantial book losses. Secondly, in medium- and long-term loans at market rates, interest payments usually account for the larger part of the total cash flow of debt service. Thus interest rate concessions would generate greater savings for the debtors. Of course, as is recommended in several proposals, interest and principal reductions can be combined.

VI. The Major Debt Proposals

This section provides summaries of the most representative debt proposals. The Baker Initiative, one of the best known and most discussed debt plans, is not reviewed here, nor are proposals for debt relief to low-income Sub-Saharan countries. For proposals with multiple features the most salient aspect (e.g. debt forgiveness in plans that combine concessions with new lending) is used for ranking.

Increased lending by official and commercial sources

Most new money proposals share the concerns of the Baker Initiative but set higher targets for new lending and, in some cases, recommend the creation of a new international agency as coordinator of conditionality. Their usual weakness is the absence of safeguards against free riding, as participation is deemed voluntary.

The de Carmoy proposal (1987) 26/

This recent proposal envisages that the governments of the USA, Japan and European countries would assume joint responsibility for increased lending to the original Baker 15 plus Poland and Romania. The plan would be implemented in stages: during an initial trial phase only three countries--two Latin American and one other HIC--would be used to test the plan's effectiveness.

After it is extended to the seventeen target countries, this plan would aim to raise new lending by at least \$30 billion per year, for ten years. Of that total, the multilateral banks would provide \$5-8 billion per year for project loans, and industrial countries \$15 billion at concessional rates. Commercial banks would provide the balance for project or trade financing. During each of the first three years of full operation, \$3 billion would be set aside in a Compensatory Financing Facility to protect debtors against unforeseen increases in real interest rates.

de Carmoy's three explicit aims are to: raise real GNP growth in the target countries to 6 to 7 percent; provide sufficient time for structural adjustment; generate "credibility" for the plan in the largest HICs. It stresses the need for a the case-by-case approach.

A central feature of de Carmoy's proposal is the creation of an Action Committee comprised of representatives of the private and public sectors of the sponsor governments. The Committee would administer total

Ltd., Harmondsworth, England, 1987; pp 55-57.

26/ de Carmoy, Herve, "Debt and Growth in Latin America: A European Banker's Proposal; Working Paper 9, Instituto de Relaciones Europeo-

lending, coordinate the commercial banks' share of total lending and coordinate agreement on the required conditionality between lenders and borrowers. The Committee's staff would be limited, as it would draw extensively on the World Bank's and IMF's design of conditionality and adjustment programs. Finally, the committee would "self destruct" after the ten-year implementation period of the increased lending is concluded.

Superseding its coordinating role, the Committee's main purpose would be to add "political momentum and weight to the process"^{27/}. In other words, it would create moral suasion for the banks to increase lending, and for the debtors to adhere to the conditionality. Beyond that organizational aspect, the de Carmoy proposal is essentially an expanded version of the Baker Initiative.

The plan's self-avowed weaknesses are its cost to industrial countries (an estimated 0.3 percent of the combined GNP of the USA, Japan and the EC in each of the plan's ten years, to cover their share of total lending), and the lack of political consensus. To this one could add the cumbersome structure of the Action Committee, the lack of sanctions against free riding, and focus on a single remedy: more debt.

Japan's recycling plan 28/

In 1987 the Japanese government pledged to recycle up to \$30 billion equivalent of its current-account surplus in favor of developing countries in two tranches of respectively \$10 and \$20 billion equivalent, the latter of which will be spread over three years, ending in 1990. This amount includes both public and private funds that will be deployed in the form of (i) supplementary budgetary allocations for credits to the IMF and IDA 8; (ii) the establishment of the Asian Development fund, to be administered by the Asian Development Bank; (iii) loans by Japanese commercial banks to the Multilateral Development Banks including the World Bank, (iv) expansion of untied cofinancing with international development institutions by the country's Overseas Economic Cooperation Fund, the Export-Import Bank of Japan (EXIM) and Japanese commercial banks; and (v) expansion of direct loans to developing countries through untied EXIM loans.

The Japanese initiative includes the creation of a Japan Special Fund in the World Bank. This fund is comprised of grants of Yen 30 billion for "untied" cofinancing by Japanese commercial banks of World Bank projects and programs. It also provides for expanded access for World Bank borrowings in the Japanese capital market, in an amount of Yen 300 billion (a total of over \$2 billion), to be spread over three years.

Latino Americanas, Madrid, 1987.

27/ Ibid.

As part of that recycling, Japan also intends to accelerate by two years its plan to double its official development assistance (ODA) to developing countries and to have ODA disbursements of more than \$7.6 billion in 1990. In 1986, the Japan's ODA already rose to \$5.6 billion, so that it has replaced France as the second largest provider of ODA, after the United States. Japan has traditionally extended much of its aid to developing countries in Asia, but in recent years, it has increased its grants to Sub-Saharan African countries.

This plan is already operating : Yen 6 billion that are part of the first tranche were deposited with the World Bank in 1987. The main criterion of success will be that the recycled funds are used for productive means by the recipient countries. Recipient governments and financing agencies will therefore need to ensure effective evaluation and monitoring of projects and programs financed by these funds. However, the plan's size should not be overestimated, at it includes funds that would have been allocated in any event (for example Japan's contribution to IDA-8). In addition, a large part of the "recycling" will involve private funds, including commercial cofinancing and enlarged access for World Bank borrowings in the Tokyo market.

New commercial lending supported by credit enhancement

The Lever plan (1983) ^{29/}

The original formulation of this plan by Lord Lever and Christopher Huhne dates back to 1983 and has been revised since then. Its central feature is partial risk coverage, comparable to that offered by the export guarantee schemes of industrial countries. The beneficiaries (creditors) would have to pay variable premia that reflect the underlying risk, and part of the risk would remain uncovered. The main difference from existing practices is that coverage would be subject to periodic ceilings, to be set by the IMF on a case-by-case basis in light of each debtor's projected negative cash flow. New loans covered under that ceiling would be subject to strict conditionality, agreed between the IMF and the borrower, aimed at stimulating growth and investment. The policies to be adopted as part of the conditionality, while necessarily "sound, even austere"^{30/}, would stress positive net transfers. They would also aim to relieve the foreign-exchange constraint on the debtors' growth.

The ceiling for new lending--originally estimated by the authors in a range of \$30 to 40 billion--could be adjusted in light of international developments: it could be increased after a new external shock to allow greater time for adjustment in debtor countries, or be reduced in periods of rising inflation. The guarantees would also aim to achieve the finest market

28/ World Development Report 1988, Box 1.3, p. 21.

29/ Harold lever & Christopher Huhne, op. cit., Chapter 9.

rates for new loans and would be administered by national export credit agencies within guidelines and ceilings set by the IMF. Consistent with the practice of export credit guarantees, the new loans would be provided by commercial banks, but the ultimate liability for defaults on guaranteed loans would fall upon the industrial countries, through the IMF.

Obviously, the borrowers could only benefit from this scheme if the guarantee premia are lower than the cost savings on risk-adjusted lending rates. But this plan offers the benefit of simplicity--there would be no new institution. It would also offer safeguards against free riding by forcing nonparticipants to write down non-performing loans and, through partial guarantee coverage, ensure burden sharing between official guarantors and private banks. However, it shares the weakness of the de Carmoy proposal by advocating increased lending, even to countries with severe debt overhangs. This may well reflect the plan's age: in 1983 the consensus was that HICs suffered from illiquidity that could be resolved by increased lending flows.

The Rotberg plan (1988) 31/

This plan emanates from the World Bank's former treasurer. Like Lever, Rotberg recommends partial guarantees. In this case only the principal amount of loans would be covered, so that commercial creditors would not need to write down their book value in the case of default. Coverage would be provided by means of complex financial engineering techniques.

Under the Rotberg plan, new commercial lending would be long-term, with maturities of up to 20 years. Those loans would run in parallel with World Bank structural adjustment loans (SALs), and have substantial balloons at the final maturity. The World Bank would guarantee the principal amount of those loans by offering a "put"--that is, a commitment to purchase. The put would be at par, cover all principal repayments, and only be exercisable after 20 years. (This explains the proposed maturities for new loans, and the need for balloon repayments.)

Lenders who exercise the put--i.e., who use the Bank's guarantee--would automatically be obliged to relend the same amount to a new World Bank affiliate for another 20 years. Those new loans would be at variable rates corresponding to the yield of 3-month US Treasury bills. The Bank's affiliate would use the proceeds of that loan to purchase the original credits.

Rotberg's approach offers the advantage of burden sharing: in return for improved protection, the lenders too would have to be prepared to make certain sacrifices: an original commitment of up to 20, plus the obligation to onlend for a further 20 years if the guarantee is exercised; low yields during the latter 20 years. A further advantage is that, except for the capitalization of the World Bank's new affiliate, the plan would be largely self-financing: the affiliate's repurchase of risk assets would be financed by the original lenders, at the finest available market rates.

30/ Ibid. p 141.

However, Rotberg's plan also has certain weaknesses. It is organizationally complex, notably in requiring the creation of a new World Bank affiliate. It involves complex financial engineering. Only new lending in US dollars would be eligible for the Bank's puts, which would exclude non-US creditors that elect to lend in their own currencies. The dollar emphasis may also be sub-optimal if it increases the dollar exposure of countries whose export earnings have a large non-dollar component. Finally, there are no "sticks" to deter free riders.

Among other credit enhancement proposals is that of First Interstate Bank ^{32/}. This plan incorporates some of the features of Mexico's securitized debt defeasance scheme of 1987: a condition of new loans by commercial banks would be that part of the loan proceeds be set aside by the borrowers to purchase US Government zero-coupon bonds that would serve as collateral.

Interest stabilization

The principles and techniques of interest-rate stabilization were set out in the previous section. One variant to protect debtor countries against future increases of the nominal cost of debt is to use the principles applied in adjustable-rate mortgages, so that a ratchet would limit interest-rate increments from one interest payment date to another. This is based on the assumption that most debtors can accommodate small variations in nominal--and real--costs, but are destabilized by extreme fluctuations of interest rates, such as those that occurred at the start of this decade.

Implementation of that type of protection would require an institutional framework, for instance an Interest Stabilization Facility (ISF), sponsored and funded by industrial countries. The ISF that would bear similarities with Interest Compensation Facility of the now defunct Herrhausen proposal ^{33/} and with de Carmoy's Compensatory Financing Facility.

Its role would be to determine the appropriate ceiling for a "moving interest-rate cap" in any given period. Maximum increments would be defined in light of anticipated interest-rate trends, and of the capacity by eligible debtors to absorb certain rate increments. The ISF would also be a central clearing house between lenders and debtors. Whenever market rates exceed the cap, the ISF would pay that excess to commercial creditors on the debtors' behalf, and capitalize it as a direct claim on the debtors. To amortize that claim, debtors would continue to pay the ISF the capped rate when interest due on the original floating-rate loan falls below the cap. Depending on whether any residual claim outstanding is extinguished at the maturity of the cap, debt stabilization of this kind could involve a concessional element, akin to interest-rate relief.

^{31/} The Economist, 5/14/1988, p 83.

^{32/} The International Economy, July/August 1988, p. 104.

The ISF's commitments could be underwritten by a pool of central banks. In practice those commitments and risk exposure are likely to be limited, even if interest rates rise over long periods of time. Extreme turbulence of interest rates, rather than steady increases, occurs seldom. Moreover, the ISF could set caps at levels that minimize its exposure. The main drawback of this approach is its operational and institutional complexity.

Debt relief through interest-rate reductions

Interest forgiveness is legally distinct from risk transformation through swaps and from the protection offered by a potential ISF. In both of the latter cases original contractual obligations towards lenders remain unchanged: although the cost of these obligations is cushioned by a market (swap) or institutional (ISF) mechanism, the lenders would not have to incur any losses. By contrast, interest forgiveness would translate into lower cash flows and loss of revenue for all creditors that grant it, unless their income loss is absorbed by a publicly-financed institution.

The Rohatyn proposal (1983) 34/

This plan combines concessional interest relief, long-term debt rescheduling and debt service payments that are adjusted as a function of the debtors' export revenues. It draws on Rohatyn's earlier success in resolving New York City's fiscal crisis with the creation of the Municipal Assistance Corporation (MAC). Based on that precedent, Rohatyn recommends the creation of a "developing-country MAC" that would reschedule commercial and official bilateral debt, and stretch out short-term debt to maturities of 25 to 30 years. The "DCMAC" would facilitate the rescheduling by offering its own long-term bonds in exchange for developing country debt. In other words, there would be a change in the ownership of risk assets.

The key feature of Rohatyn's plan is interest relief. DCMAC bonds would carry a fixed concessional rate (6 percent was proposed at the time) that would be passed on to the debtors whose debt is rescheduled. Banks that accept those bonds in exchange for their original loans would incur an immediate loss, due to the lower present value of the revenue stream on the bonds. As a compensation for that sacrifice, they would acquire assets in a better risk category. They would also be permitted to write off the revenue loss. For their part, industrial country governments would guarantee the agency's bonds and underwrite its potential debt-service losses on the loan portfolio it has acquired from the banks.

A final, important feature of the Rohatyn proposal is that the debtors would commit themselves to maintaining debt service equivalent to 25

33/ World Debt Tables 87-88, Box 5.

34/ Rohatyn, Felix, G. "A plan for Stretching Out Global Debt", Business

to 30 percent of their export revenue. This recognizes the linkage between export and debt-servicing capacity, and states that debt-service ratios in excess of the proposed limits are unsustainable in practice. But, despite its potential merits for HICs with severe debt overhangs and uncertain export prospects, this early plan shares the cost implications, organizational complexity and absence of political support of other debt relief proposals.

The Bradley "Proposal for Third World Debt Management" (1986) 35/

This is a hybrid and ambitious expansion of the Baker Initiative. It centers on annual Trade Relief Summits that would include the World Bank, commercial banks and creditor governments. These summits would overcome the logistic problems created by the fragmentation of the debtors' respective negotiations with two separate creditor "clubs": the London Club of commercial lenders and the Paris Club of bilateral official creditors.

Like Secretary Baker, Senator Bradley envisaged a three-year period for the implementation of his plan. During that period consecutive annual Summits would agree to provide a combination of concessional interest and principal relief, as well as additional lending. Debt relief in each of the three years would amount to a maximum of three percentage points off actual interest rates and three percent write-off of all outstanding commercial and bilateral official loans, and to be forgiven by them. The actual amount of relief to any one eligible country would be negotiated under that ceiling.

Reciprocal commitments of debtor and creditor nations would be, for the former to undertake domestic reforms, and for the latter to ensure a better trading environment for developing countries. Finally, as in the Baker initiative, the multilateral development banks would have to increase their lending by \$3 billion per year, over three years. However, recognizing that the commercial banks' principal aim is to lower their risk exposures to HICs, the Bradley plan does not provide for new commercial lending.

In aiming to provide debt relief, Senator Bradley's proposal is more ambitious than the Baker initiative. It is also more pragmatic than the latter. For instance, the proposal deliberately excludes new bank lending (as noted earlier, commercial lending failed to meet the Baker targets), and the suggested level of debt relief, though limited, anticipates the needs of countries with severe debt overhangs. This proposal's main weaknesses are its short time horizon of only three years, and the budgetary implications of interest and principal concessions by official creditors.

Week, 2/28/83, pp15-18.

35/ P.Wertman, "The International Debt Problem: Options for Solution",
Congressional Research Service, Library of Congress, Washington D.C.,

The Kerry proposal (1986) 36/

This plan offers a more complex form of interest-rate relief. Senator Kerry advocates the creation of an International Debt Program (IDP), to be managed by the UN's International Trade and Finance Development Council. IDP would relate debt service to a given debtor's trade balance and combine interest forgiveness, debt service capping and debt rescheduling.

Debt-service capping would make payments a function of trade surpluses. If the surplus is 20 percent or less of a country's exports, debt-service payments would be limited to 20 percent of exports and increase proportionally, in line with the surplus. For countries with trade deficits, debt would automatically be rescheduled according to a progressive scale, based on the ratio of the trade deficit to total exports. A deficit equal to 20 percent of exports would entitle the country to automatic rescheduling of 20 percent of its debt, etc., subject to a ceiling of 40 percent.

All rescheduled amounts would be capitalized and entitle the debtor to interest relief. For the first five years all interest on rescheduled debt would be paid by the IDP. For the next ten years, interest would be capped at 3 percent, with the remainder paid by the IDP. Finally eligible debtors would establish a reserve against future default, equivalent to 10 percent of the relief they have received.

A major difference between the Rohatyn and Bradley proposals and the Kerry plan is that, under the latter, commercial lenders would not suffer a loss of revenue. Industrial nations would fund the IDP's disbursements in a manner proportional to the trade benefits they enjoy as a consequence of the debtors' relief. The difficulty of gaining public support for that cost feature is a major stumbling block.

The Bank of Nova Scotia proposal (1987) 37/

This is one of the few debt plans made by a commercial bank that is also a creditor to HICs. Its central feature is that the amount of interest-rate relief would be set so that debt service could be a "reasonable burden". In each case, the amount of relief would be determined in light of the debtor's exports and GDP. Relief would be granted equally by all existing creditors, but would exclude trade credit.

Rather than being forgiven, the amounts by which original interest charges are reduced would accrue to lenders in the debtor's local currency at a pre-agreed exchange rate and would be available for conversion into equity investment in the debtor country. Finally, relief would be subject to a

10/17/86

36/ Wertman, Patricia, op.cit., CRS 10/17/86, pp 24-26.

37/ Bank of Nova Scotia, A proposal regarding developing-country debt. Mimeo,

ceiling and future interest defaults or arrears would be covered by an Insurance Fund. That Fund would be managed by an existing multilateral bank and capitalized by commercial, bilateral official and multilateral lenders in proportion to their exposure. The World Bank and IMF would oversee the implementation of the relief plan, apply the necessary conditionality and commit themselves to continued lending to the debtors concerned.

This plan has several merits. Local currency balances could serve to promote VDR through debt-equity swaps; the World Bank and IMF would set surveillance of conditionality criteria; there would be a case-by-case approach. Moreover, it could serve to stimulate new commercial lending by tying it to the disbursements of World Bank loans, and the debtors would have to forego certain interest-rate concessions if commodity prices rise. However, on the debit side one should stress the risk of inflation, caused by the expansion of the domestic money supply in the debtor countries.

The Dornbusch plan (1988) 38/

This proposal by a leading US academic takes Nova Scotia's approach one step further. It advocates that all interest payments in foreign currencies be suspended for an undetermined period, and accrue instead in the creditors' favor in local currencies. This could ease the way for debt-equity swaps, as local currencies could be reinvested locally, but not repatriated. As a complement, debtors would undertake major policy reforms. This plan shares the inflationary risks of Nova Scotia's proposal.

The Miyazawa plan (1988) 39/

This second Japanese initiative was presented at the 1988 Toronto Summit. Its structure is threefold and combines menu options and interest reduction. First, debtor nations would securitize part of their debt, with principal guarantees through liens on their exchange reserves and on the proceeds of the disposal of state-owned assets. Second, the remaining, unsecuritized debt would be rescheduled with grace periods of up to five years, during which interest payments could be lowered, suspended or forgiven. Finally, multilateral and bilateral agencies would increase their lending to countries that had taken the first two steps.

The main drawback is that countries with scarce reserves would not be able to provide collateral security for principal repayments. Eligibility to this plan would thus be restricted to debtors that have sufficient foreign-exchange reserves.

4/30/1987.

38/ New York Times, 5/13/1988.

Debt relief through the reduction of debt stocks

Most debt reduction plans share the feature that ownership of risk assets would be transferred to an IDF-type agency, in exchange for its own debt obligations. This transfer of ownership would sever the link between private creditors and official debtors, and insulate creditors from any further deterioration in the debtors' creditworthiness, thus protect the international financial system.

The Kenen plan (1983) 40/

This proposal was the first to recommend the creation of a new agency, the International Debt Discount Corporation (IDDC), envisaging that it could function within the IMF. IDDC's capital would be subscribed--in paid-in or callable form--by industrial countries. In exchange for its own bonds, IDDC would purchase debt at 90 percent of face value--a low discount, given today's secondary loan prices. IDDC bonds would have a final maturity of 15 years, a five-year grace period and a yield tied to US Treasury bonds. They would be tradable. IDDC would reschedule the loans it had purchased to the same final maturity, but with a grace period of only three years, and a cost to debtors of a quarter percent above the issue yield of the new bonds. Again the terms of the proposed reschedulings have been surpassed by recent market practice.

The principal merit of Kenen's scheme is that, in being the first to propose reductions of debt stock facilitated by a new international, publicly-funded facility, it has become a "generic plan". Its obvious cost is the need to appropriate public funds to underwrite IDDC's capital and potential losses on the loans it had taken over.

Though subsequent debt-reduction proposals vary in coverage and detail, they mostly follow Kenen's broad principles. 41/ They generally also share its costs. For example, the Sengupta Proposal 41/ of 1988 envisages an IDDC-type facility, to be created in the IMF (the IMF Debt Adjustment Facility). Similarly, the Mistry Proposal 42/ recommends the creation of a Debt Restructuring Facility, to be administered as a special World Bank program. By contrast, Sachs 43/ recommends purchases by the World Bank itself, in exchange for its own bonds.

39/ The Economist, 8/6/88, p 62.

40/ Wertman, op. cit., pp 29-30.

41/ Sengupta, Arjun K. "Remedy for the Debt Overhang", The International Economy, July/August 1988, pp. 97-99.

42/ Mistry, Percy S., Third World Debt: the Baker Plan - Phase II, undated mimeo.

The Robinson plan (1988) 44/

This plan is more ambitious than its predecessors. It combines debt reduction with voluntary new lending. The plan's central structure is a new international debt agency, the Institute of International Debt and Development, (I2D2). I2D2 would be a joint venture of the World Bank and IMF, and rely heavily on their staff. Sponsoring governments would provide its equity capital.

I2D2 would negotiate case-by-case agreements with debtor countries. If the latter agreed to participate, they would have to commit themselves to growth-oriented policies. All participations by sponsoring and debtor governments would be completely voluntary.

With creditor banks I2D2 would negotiate the repurchase of debt at a discount, in exchange for its own obligations. These would be of two kinds: floating-rate perpetuals, and participating preferred stock. The purchase discount would be determined in light of the probability of debt service by the debtor, of the secondary-market price of the debt involved, and of concessions that are deemed appropriate to make debt service more sustainable. In return for that discount I2D2 would grant the debtors "meaningful concessions" during the adjustment period.

I2D2 would also reserve the right to subordinate the debt so acquired to all future debt of the same borrower, to pave the way for new voluntary lending to that country. However, both the original concessions and the subordination could be suspended by I2D2 if the debtor(s) were to deviate from agreed adjustment plans or to exceed targets for new senior lending. Given the subordination feature, and to avoid free-rider problems, all the commercial debt of a given country would either have to be acquired by I2D2, or treated comparably.

In Robinson's estimate, up to \$250 billion in commercial debt of the Baker 17 would be eligible for repurchase. Assuming the total amount were repurchased at 60 percent of par, I2D2 would have to issue a maximum of \$150 billion in its own obligations, respectively as to \$125 billion in perpetuals and \$25 billion in preferred stock. Assuming a 10:1 gearing ratio, I2D2 would require \$12.5 billion in equity participations by sponsoring governments, either paid up, or callable. Such capital would be kept as reserve by I2D2.

One weakness of this proposal is that if I2D2 subordinates the debt it has acquired from banks, its risk exposure could be considerable. On the other hand, that subordination would be a "carrot" for new lending. As another carrot to promote the enforceability of this essentially voluntary

43/ The New York Times38, 8/9/1987.

44/ James D. Robinson III: (i)"Weaving a Debt Net", The International Economy, May/June 1988, pp. 50-55, and (ii) The Amex Bank Review, Special Papers, No 13, March 1988, "A Comprehensive Agenda for LDC Debt and World Trade

plan, Robinson suggests that bank regulators treat discount from the debt's face value as an eligible reserve in the banks' base capital, or that its write-down be spread out over time. However, it is not clear how a discount--i.e., a loss--could become an eligible reserve.

Robinson proposes to deal with free riding in two ways. Non participants would either be offered low-yield exit bonds, or be mandated by regulators to mark the loans concerned "to market", without the benefit of the special reserve treatment or spread write-downs the participants would enjoy. But, as the proposed inclusion of discounts in the banks' reserves is questionable, that part of the stick loses some of its "clout".

The UNCTAD plan (1988)

This proposal was set out in UNCTAD's Trade and Development Report 1988, and calls for across-the-board debt reduction. UNCTAD starts from a medium-term baseline scenario for the Baker 15, and recommends once-and-for-all debt forgiveness of 30 percent of the commercial bank debt of those countries (equivalent, in UNCTAD's estimate, to 25 percent of their total debt).

Simplicity is the principal advantage of UNCTAD's approach: the banks would act directly to make write-offs, without the intermediation of a new debt facility. However, this does not tackle the questions of enforceability and free riding, except through burden sharing with the debtors (the proposed discount of 30 percent is far below average market discounts of around 50 percent). The cost of the proposed forgiveness is estimated to be compatible with the banks' existing provisions.

The sole condition to be imposed on debtors would be to allocate the entire amount of interest savings--estimated at \$10 billion in the first year--to investment in export industries, so as to generate additional foreign exchange when exports grow. Domestic consumption would only expand later, in line with GDP growth.

UNCTAD estimates that debt forgiveness of that magnitude would immediately raise income growth in the Baker 15 to 7.2 percent, and that average growth of per capita income over the next five years would reach 3.1 percent, or 2.5 percent more than in the baseline without forgiveness. These projected growth rates are substantially above the World Bank's "high case" scenario, presented in the 1988 World Development Report

The Gorbachev plan (1988) 45/

This plan was announced at the occasion of President Gorbachev's speech to the UN General Assembly on December 7, 1988. Besides a declaration of intent, that the U.S.S.R would institute a moratorium of up to 100 years on

Growth".

its claims on the least developed countries, this plan also addresses the problems of HICs.

For the latter group of countries the Soviet proposal endorses UNCTAD's debt reduction plan. It also recommends that debt service payments by HICs be a function of economic performance and that, in selected cases extended (but not specified) payment deferral be given on major portions of debt. Finally, this plan expresses support for "market agreements" (presumably VDR) with industrial-country guarantees. It also supports the establishment of an IDF, if needed.

Though laudable, this plan may be somewhat disingenuous. The U.S.S.R. is a major debtor in its own right and its Foreign Trade Bank has only a very limited risk exposure in HICs.

VII. Conclusions

Proposals to increase official and commercial lending to the HICs have received widespread support. Some are already being implemented. Japan's recycling plan is in force; the World Bank's recent capital increase will enable it to expand its own project and program lending. Through co-financing programs, direct guarantees and other techniques, the World Bank and its affiliated institutions, IFC and MIGA, are expanding their catalytic role to stimulate commercial lending to selected HICs. Risk hedging is also being implemented on a selective basis. A small number of developing countries have already introduced interest and currency swaps in their debt management programs.

By contrast, official circles in industrial countries and commercial creditors have, so far, shunned the idea of interest concessions or debt forgiveness to HICs. For governments the major obstacle is the potential use of public funds ("tax payers' money") to finance debt concessions directly, or to protect their domestic banking systems against the financial impact of such concessions. For their part, the banks fear that large-scale "involuntary" debt reduction would involve excessive losses and write-offs. If these were to exceed existing loss provisions, capital-erosion could affect the more highly leveraged banks. Finally, both official and market circles point to the risk of moral hazard by debtors, meaning that formal concessions could become a "reward bad conduct", thus penalise countries that have persevered with adjustment.

Arguments against formal debt concessions to HICs have also been bolstered by the fact that recent breakthroughs in market-based debt strategies have already managed to provide some degree of debt reduction, thus relieving some of the tension associated with the debt overhang. Voluntary debt reduction is gaining wider acceptance from commercial banks and, as shown by Brazil's debt rescheduling agreement of late 1988, there is an emerging consensus in banking circles that VDR need not preclude new lending to the same country. A further major breakthrough in this field could be provided by the Brady initiative ^{46/} of March 1989. This new initiative by the US government actively promotes the expansion of VDR. To support and encourage action by commercial banks, the initiative recommends regulatory changes--including a three-year waiver of sharing and negative pledge clauses--to provide banks with the necessary flexibility in their negotiations with debtor countries. It also provides for the use of IMF and World Bank resources, as collateral on future (presumably lower) interest payments by selected debtors.

These recent developments point to the fact that there are at least as many reasons to reject interest and/or debt forgiveness as to support it.

^{45/} The New York Times, 12/8/88, p. A16.

^{46/} This initiative by US Secretary Brady was announced on March 10, 1989. As this paper was written before the announcement of that initiative, it could not

However, it is also increasingly apparent that the main arguments against any form of broad-based debt concessions to HICs--beyond voluntary action by commercial creditors--are political and ideological. Political opposition comes from the industrial countries' reluctance to tackle the sensitive issue of appropriating public funds for debt relief in an environment of budgetary austerity. Ideological objections are that a "market" problem--debt recovery by private commercial banks--cannot, or should not, be resolved with non-market means.

Both arguments, however, tend to gloss over the increasing politicization of the debt problem in the debtor countries themselves. Tardy or insufficient adjustment can no longer be ascribed solely to economic mismanagement. In several Latin American HICs--especially in the new, often precarious democracies of that continent--political opposition to forced domestic austerity and budgetary compression is often the main cause of the governments' vacillating commitment to socially taxing adjustment. At the same time, being seen to take a strong stand against foreign commercial creditors can be politically expeditious to defuse mounting domestic tensions, even if it proves financially ruinous in the longer run. Peru and Brazil offer good examples of such ill-fated attempts.

So far the creditors have managed to remain one step ahead of the debtors. Banks have trimmed their exposures and accumulated large provisions to lessen their vulnerability to potential defaults; the evolving debt strategy has become sufficiently pragmatic to recognize the need for more wide-spread VDR; as isolated crises flare up in individual debtors, industrial countries and multilateral agencies can step in with sizeable emergency loans or commitments to lend--most recently to Mexico and Argentina. But, even though the international financial community has been willing to raise the stakes as and when needed, after seven years the debt strategy has not yet moved beyond the realm of crisis management.

The outcome is still fraught with uncertainty, especially now that some Latin American debtors are attempting to revive the idea of a "debtor cartel". If that should happen, or if social and economic problems were to become even more pronounced in HICs--for instance, in the event of a new world recession--crisis management may no longer suffice. It will then become obvious that a purely political decision is needed to remove remaining hurdles in the path of formal, involuntary debt forgiveness. In fact, the amount to be forgiven under such conditions could turn out to be higher than if more timely action had been taken. The current S&L crisis in the United States shows only too well that delayed action can be very costly indeed.

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